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## DIRECTORATE OF INTELLIGENCE

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China: Learning To Control Construction Growth 

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## Summary

China's excessive capital construction continues to cast a shadow over long-term growth plans by fueling inflation, undermining critical infrastructure projects, and straining resources. The growth of nonbudgeted construction--largely in the consumer and processing industries--has forced Beijing to increase its reliance on poorly developed macroeconomic levers to control expenditures. Budget cuts are a less attractive option, for budgeted projects consist largely of crucial infrastructure projects. Beijing has now taken a firmer hand, directing cutbacks in specific projects and increasing the banking sector's role in allocating funds. Because Beijing does not have the expertise or information to control spending through the banking system, we expect construction growth to remain a headache for economic planners at least through next year.

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Information available as of 14 January 1986 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Economic Assessments Branch, China Division, OEA,

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### Accelerating Growth in Capital Construction

Capital construction<sup>1</sup> in China has expanded rapidly in the 1980s, largely as a result of the transfer of investment and construction decisions to the local and factory level. Since 1979, Beijing has allowed state-owned enterprises to supplement construction funds granted or loaned from the state budget with off-budget loans. Collective and private enterprise also gained access to bank loans to supplement their savings in financing new construction. All forms of enterprise were quick to capitalize on this source of finance (see table 1). At state-owned enterprises, the annual growth rate for capital construction averaged 34 percent in 1983-85, a sharp increase over the 16-percent growth in 1981-83. At collective and private enterprises, construction activity grew even more quickly--about 45 percent annually in 1983-85. With the growth of off-budget loans, the share of construction financed through the state budget has fallen sharply (see table 2).

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### Concern Over Construction Growth

The construction binge has worried Chinese policymakers. Their statements in the press have shown concern that energy and materials shortages, inflation, and tight financing will threaten the economy's growth into the 1990s if excessive investment and construction continues:

- Most of the projects financed outside the budget are in consumer goods and processing industries that have high profit potential, and draw resources away from desperately needed improvements in energy and transport facilities. When completed, these projects add to, rather than relieve, demands on China's overstrained infrastructure.
- The expansion of construction has been much more rapid than growth in the steel and building materials industries--38-percent annual growth in capital construction in 1983-85 versus 16 percent in cement and plate glass and 10 percent in timber and rolled steel--and shortages of these goods have delayed both budgeted and extrabudgetary construction projects. According to Chinese economic journals, incomplete capital construction projects have doubled in five years.
- Competition for available materials has bid up prices and strained construction budgets. Beijing claims China's worst inflation--9 percent annually--is in the building materials industries.

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<sup>1</sup> Capital construction is roughly equivalent to the Western concept of gross domestic fixed capital formation; it includes primarily additions to the stock of fixed assets. However, it only partially includes replacement investment and excludes repairs or renovation.

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**Table 1** **Billion Yuan**  
**Capital Construction Expenditures in China 1981-85**

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	1981	1982	1983	1984	1985*	Annual Growth 1983-85 (percent)
State-owned enterprises	44.3	55.6	59.4	74.3	107.4	34.4
Of which: on-budget	25.2	27.7	34.6	40.4	42.2	10.4
: off-budget	19.1	27.9	24.8	33.9	65.3	62.1
Collective Enterprises**	NA	NA	9.8	15.0	20.9	46.5
Individuals and Individual Enterprise**	NA	NA	16.3	25.6	34.2	45.0
Total	NA	NA	85.4	114.9	162.6	37.9

Totals may not add due to rounding.

\* Provisional Data.

\*\* Estimated. These estimates almost certainly understate capital construction financed by collectives and individuals. They are derived from State Statistical Bureau data (available only after 1983) for collectives' and individuals' total investment in fixed assets--of which capital construction is a subset with no data provided. As a conservative measure, we assumed that capital construction's share of total fixed asset investment in these sectors was comparable to that in the state sector. Actually, because collective industry is usually more labor intensive, more of collectives' fixed assets investment goes into capital construction (buildings) and less into machinery and equipment. Most fixed assets investment by individuals (68 percent) goes into residential construction with little into machinery. Thus the capital construction shares of fixed asset investment in these sectors are almost certainly higher.

Sources: State Statistical Yearbooks; provisional data from State Statistical Bureau's China: A Statistical Survey in 1986.

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In addition, off-budget loans, especially in rural areas, frequently finance construction of factories equipped with inexpensive but antiquated and inefficient machinery, often salvaged from urban enterprises under renovation. This frustrates China's efforts to meet waste-reduction targets in energy consumption, which are critical to its production targets.

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**Table 2** **Percent**  
**China: Budgeted Versus Off-Budget Expenditures on Capital**  
**Construction**

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	1981	1982	1983	1984	1985
Share of state-owned enterprise capital construction expenditures					
Budget:	56.8	49.8	58.2	54.4	39.2
Off-budget:	43.2	50.2	41.8	45.6	60.8
Share of total capital construction expenditures					
Budget:	NA	NA	40.5	35.2	25.9
Off-budget:	NA	NA	59.5	64.8	74.1

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### Failed Cutbacks Lead to New Control Efforts

Beijing announced early in 1986 intentions to hold capital construction expenditures in 1986 and 1987 to the 1985 level. Nonetheless, according to press reports, through September construction outlays by state-owned enterprises alone<sup>2</sup> both in and out of the budget totaled 62 billion yuan, a 9.5-percent increase over 1985.<sup>3</sup>

<sup>2</sup> Data have not yet been released for collective and individual expenditures.

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<sup>3</sup> This third-quarter figure appears much smaller than last year's total. However, because of the budget cycle, capital construction outlays rise dramatically in the fourth quarter.

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Although Beijing has expressed limited satisfaction with this growth rate--substantially lower than the 1985 growth rate of 44 percent--we believe this figure seriously understates actual expenditures. Beijing has admitted in the press that state firms seeking to avoid project cancellations or postponements often disguised new projects by labeling them renovations, a separate item in the budget excluded from construction controls. If we include the 45-percent growth in renovations in the first three quarters of 1986 over the same period in 1985, we estimate that capital construction this year has grown by as much as 21 percent. [REDACTED]

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### **Measures To Trim Budgeted Construction**

In August, reacting to sustained growth in construction expenditures, Beijing announced plans to review all outstanding construction projects by state-owned enterprises. During the ensuing three months, the State Planning Commission checked projects for feasibility, availability of materials and funding, level of embodied technology, and the extent of duplication of projects nearby. Following review, projects were considered for funding reductions, postponements, or cancellations. Beijing announced in November that the number of projects under construction through September had been cut by 3,700 from 1985; the number of new projects begun in 1986 was down by over 7,500. The total number of projects outstanding was not given, but on the basis of State Statistical Bureau data listing more than 69,000 projects under construction by state enterprises in 1984, we estimate the project cancellation rate was only about 5 percent. [REDACTED]

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Even these numbers may overstate how much China has cut back construction activity. Beijing has admitted that its efforts to cancel excess projects in the 1982-83 budgets were frequently thwarted at the local level, where officials used "cost overruns" at projects still on the books to sustain construction of projects Beijing had ordered canceled. In the current cutback effort, press reports claim that "not a few" localities and departments purposely submitted incomplete lists of projects for central review to avoid cancellations and postponements of many costly items. [REDACTED]

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### **Using the Finance Sector To Control Extrabudgetary Construction**

With off-budget funds now financing nearly three-fourths of China's capital construction, Chinese financial authorities recognize the need to monitor funds and deposits by local banks, and to maintain checks and balances on both banks and borrowers. [REDACTED]

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Through early 1985, the People's Bank of China (PBOC) tried to curb loan expansion by:

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- Raising interest rates on loans for both construction (up to 10.08 percent for five-year loans) and working capital (up to 7.92 percent).
- Restricting loan disbursements to collectives to 50 percent of project costs.
- Requiring that applications for off-budget construction loans be accompanied by deposits equal to 30 percent of the value of the loan sought.

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For highly profitable enterprises flush with funds, however, these restrictions probably have done little to discourage further investment.

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At the same time, according to economic journals, China's financial system offered banks little incentive to follow central guidelines on credit control. No meaningful penalties existed for exceeding credit limits; local banks could borrow money at low rates from the PBOC and make substantial profits by relending it to enterprises. Although the PBOC disapproved of the practice, its accounting mechanisms were insufficient to monitor local bank activities. Moreover, local banks, under pressure from provincial and city governments not to cramp expansion plans, often failed to collect taxes on local funds available for construction, or taxed all enterprises uniformly at the minimum rate.

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China has indicated that in August it finally took steps to control lenders as well as borrowers. The PBOC has reduced incentives for local banks to run up excess loans by raising the cost of PBOC funds to banks by as much as 6 percentage points. Temporary loans--borrowings from the PBOC intended to allow local banks to meet emergency cash shortages--can no longer be extended indefinitely, reducing their abuse by local banks as an additional source of money for loans to enterprises. Finally, the PBOC raised by 1.4 percentage points the interest rate paid to banks on their deposits of excess reserves with the PBOC; this reduced the advantage to the local bank of lending that money.

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### On the Right Course...

Although these measures are a step in the right direction, we doubt that Beijing will gain control of capital construction in the short term. To restrain nonbudgeted projects, the PBOC needs better control over--and better accounting information about--local banks' activities to make certain that credit limits are observed and that borrowers conform to central bank lending regulations. Moreover, the Chinese will find it increasingly difficult to cut budgeted projects, which focus on crucial infrastructure projects. Chinese economic journals, for example, have emphasized that Beijing will allocate a much larger share of budgeted construction in the Seventh Five-Year Plan to energy and transport. As a result, until China develops the macroeconomic levers to control spending, we expect the dangers of excess construction activity--inflation, shortages, and delays for key projects--to pose continuing problems for China's modernization strategy.

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